Public/Private Development Partnerships – The Long Term Ground Lease

by

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Introduction: Public debt restrictions, federal revenue sharing reductions and similar public revenue deflaters, as well as public pressure to decrease the public’s tax burden, have created the necessity for governmental and quasi-governmental bodies to seek alternative fundraising sources to provide the capital required to continue essential operations. Many of the alternative fund raising mechanisms have had a dramatic impact on development activities because the source of first resort for raising funds has been to tack on a variety of fees and charges to any new development opportunity. This has led to the imposition of user fees for a variety of governmental services, particularly in the development process (permit fees, processing fees, inspection fees), that effectively privatize many governmental services. Additionally developer fees support, for example, school construction, fire and police services, park land acquisition, public art projects and even shelters for the homeless.

Some may suggest that these fees merely serve to offset the various giveaways to developers and businesses that have become almost a necessity to attract certain types of development, particularly development that will create a public good, such as assisted living facilities or low/moderate income housing, and development that will generate sales tax revenue, such as retail facilities. The giveaways, many of which are legislatively sanctioned, include (i) tax increment financing, whereby a government entity may barter property tax increases resulting from new construction for the private provision of a public service, (ii) special assessment, community facilities or other special districts which are created to finance infrastructure or public facilities outside of property tax restrictions, and (iii) grants or low cost loans that finance publicly desired facilities, particularly housing. But the most interesting development of the past ten to twenty years has been the dramatic increase in public participation in traditionally private entrepreneurial activities.

Every governmental and many quasi-government entities - cities, counties, school districts, special water and sewer districts, universities, governmental development corporations, etc. - own real property. Developers need property to develop. That is obvious. Government entities need money. Historically, excess land, raw or improved, was sold for immediately available operating funds. If a school was no longer required due to changing demographics, it was sold. Properties were not leveraged or otherwise treated as an endowment for the future. Short term thinking predominated. While it is true that some government entities had retained real estate and ground leased it to developers, the primary purpose was not income generation for operating needs, but rather development and aesthetic controls and other non-financial considerations.

In the past ten to fifteen years the trend has shifted and now these entities to look at their real estate holdings from a profit potential, perspective. The basic options available to these entities are to either (i) utilize their governmental power to provide or secure governmental entitlements (permits, zoning changes, etc.), and sell the property for a profit, with the entitlements in place, (ii) develop the property on their own, as an owner operator, (iii) contribute the property to a joint venture with a private developer, or (iv) ground lease the property to a private developer in a quasi-joint venture. This is not to suggest that government entities during recessionary times no longer take a short term
view of the profit making potential of their real property holdings. Some of the original securitization transactions have involved government entities peddling the income stream of their income producing properties in securitized pools in order to raise immediate operating funds.

The long-term ground lease has become a primary tool of government entities in their asset management and income maximization activities. Quasi-government and non-profit entities have also adopted the long-term ground lease for their purposes. It is not a new tool. Private landowners who are unwilling to sell their land for a variety of reasons, not the least of which are the income tax implications, have been using it for a long time. But the economic sophistication of its use is a relatively recent development for all players and the government entities have been a primary beneficiary of the increasing sophistication in the structuring of the variety of income streams in ground lease transactions. The long-term ground lease is like any other investment of funds. Structured properly, it can provide both immediate income which will increase over time as the value of the land increases and future income measured by the capital appreciation of the property. Unlike other investments, the government entity’s residual interest in the property insures the return of its property, improved by the private developer, at the end of a fixed term.

Additionally, the long-term ground lease provides many non-economic benefits to the government entity. These include (i) avoiding the ownership liabilities of the self-development or joint venture structures, (ii) encouraging architectural enhancement, (iii) controlling development in a rational manner, (iv) providing redevelopment and urban renewal incentives, (v) integrating other public purposes into the project at low or no public cost, e.g., leaseback of space for public purposes, daycare facility requirements, on-site sewage treatment requirements, on and off peak public parking arrangements, etc., and (vi) integrating the site with adjacent sites owned by the government entity or others.

The Request for Proposals: The process pursuant to which ground lease transactions are completed generally involves an “RFP,” a Request for Proposals, which is issued by the government entity. Often a precursor to the RFP is the “RFQ” or “Request for Qualifications”, issued by the government entity seeking to limit the pool of proposers to those developers who are viable candidates for the development opportunity. Since this is at its core an income generating proposition for the government entity, it is in its interest to create an opportunity that will maximize its potential revenue, even if it must use its public activities to enhance the opportunity. Therefore, to be successful, a considerable amount of preparation (and expense) is required (although recently government entities have attempted to minimize expenses by requiring developers to pay for certain of the costs of the government entity in the negotiation process). The goal of the prospective lessor should be to present an RFP that exhibits profit potential to private developers with limited risk. Risk need not be eliminated, but governmental power can be utilized to the advantage of the project to minimize it before publication of the RFP and thereby command a higher price. Spending money, of course, may be at odds with budgetary constraints, but providing entitlements, waiving fees, etc. costs the government entity nothing in immediate cash. The government entities do, however, walk a fine line between actions taken in their proprietary capacity and their governmental capacity. Many government entities do not believe that they can contract away their governmental power, yet it is not unusual for a government entity to agree not to condemn a ground leased property, or to apply
policies and ordinances in a nondiscriminatory manner.

Consultants and lawyers are an important part of the process in developing an attractive RFP. Financial, legal, feasibility, architectural and engineering advice is essential. The consultants will aid in the development of the economic and architectural objectives of the government entity, and the establishment of criteria against which to measure the various proposals. Such financial, architectural and engineering criteria should be a part of the RFP. In a far sighted RFP, feasibility studies should be made available for a nominal price or for free. What should matter to the government entity is the ultimate consideration that it will receive from the developer, although, one must acknowledge that far sighted thinking is the antithesis of the public policy in a term limited environment.

Securing governmental entitlements such as zoning changes, planning approvals, floor area ratio transfers and development agreements before or during the RFP process is an activity for which government entities are uniquely suited. There is no doubt that in a climate of overwhelming governmental control of the private development process (and the costs and delays to the developer), the value of the entitlements can be enormous. The extent to which pre-RFP entitlements are made available may well be a function of the location of the project and its public sensitivity. The vesting of entitlements will be vastly more valuable where there are major legal and political restrictions than where these conditions do not exist, and developers are willing to pay major dollars for this. Additionally, for a number of particularly sensitive projects with overlapping governmental jurisdictions, the establishment of intergovernmental cooperation and property/sales tax sharing arrangements may be negotiated by the government entity and presented as a done deal in the RFP.

The RFP may be distributed in a limited or open competition depending on legal requirements. For many projects, the pool of realistic developers may be small enough that some are personally requested to submit proposals. It is not unheard of for some developers to be consulted on feasibility issues pre-RFP.

Typically, an RFP will contain (i) a description of the contemplated project, (ii) a statement of goals and objectives, (iii) a general description of the expected term of the ground lease and the general economic expectations of the government entity, (iv) a description of the expected development proposal, and (v) in an effort to compare apples to apples, mandatory valuation assumptions and projections. The nature of the project will determine the proper response time, with four to five months normal for major projects. A significant deposit is normally required to be submitted with a proposal.

Analysis of the proposals will be based on the goals of the government entity, economic, architectural or otherwise. Occasionally submissions may be requested to be clarified. The best economic proposal may not be the best overall proposal if it comes from a relatively inexperienced developer. The primary criteria will be (i) developer qualification based on track record, experience in similarly situated projects and financial capability, (ii) financial benefits in terms of total economic return, guaranties, upside risk and project appreciation, and (iii) project qualities evidenced by the proposed architecture, design, materials and consistency with public goals.

**Developer Selection:** The government entity will normally select one developer with whom
it will enter into an exclusive negotiating period. Often a Memorandum of Understanding or term
sheet is negotiated for the ultimate approval of the publicly elected officials of the government entity.
Additional deposits may be required. During this period the precise basic terms of the transaction
and the ground lease will be negotiated. The more specific elaboration of terms will be negotiated in
the final ground lease document. The devil, of course, is often in these details, but if the parties get
through the initial Memorandum of Understanding/Term Sheet stage, it is rare for the specifications to
kill the deal. However, it may often be the case that backup offers are requested in, the event
negotiations with the selected developer are unsuccessful.

**Development and Disposition Agreement:** The operative document to implement the
transaction is frequently a Development and Disposition Agreement (“DDA”). If the scope of
government financial incentives to the developer is limited, that parties may use an Option Agreement
instead. Whatever the form, the document will set forth the conditions that must be satisfied before
the developer may compel the government entity will execute the ground lease, as well as provide the
developer with the flexibility to make sure that the development is truly feasible and financeable before
finally committing to the deal. A DDA is similar in many respects to a typical Purchase and Sale
Agreement. It is different in that it will also describe the government entity incentives (grants, low cost
subordinate loans, etc.), if any, to the developer, as well as cost sharing arrangements, etc that might
be agreed upon. The DDA will also typically provide for a Schedule of Performance, setting forth the
time within which certain activities must be completed. Rarely is the Schedule of Performance
considered to be cast in stone in light of the uncertainties of the development process, and a
mechanism is almost always provided for revisions to the Schedule in light of this.

**Ground Lease Terms:** The sophistication of financial consultants on both sides has meant
the negotiation of increasingly creative economic terms in the ground lease; but there are limitations
imposed by the inherent value of the asset, the requirements of institutional lenders who will fund the
development on the security of the leasehold, the profit incentives to the developer and, for non-profit
entities, the vagaries of the Internal Revenue Code. The more aggressive the government entity is on
the economic benefits, the less likely it will be for a developer to attract the development capital
required for project completion, operation and profit. Also, to the extent that the government entity
has a number of similar or related ground lease projects within a particular geographical area, there
are constraints imposed by the fairness of each deal struck to deals previously made and to be made
in the future. A government entity is asking for a political headache if the terms for similar deals are
dramatically (or even minimally) different.

**The Term.** The term of the ground lease is a primary concern. The government entity may
have legal restrictions on the length of the term. It also has an economic interest in the realization or
further leveraging of its residual as soon as possible in order to accelerate income potential or
promote other social goals. The developer will require a term which will permit appropriate
development phasing, if necessary, a fair return on investment and, in today’s world of sophisticated
equity investors, a legitimate and profitable exit strategy. Also, a relatively short term will reduce the
number of lenders willing to provide financing secured by the leasehold, and at the very least, may
reduce available loan proceeds (with shorter amortization periods, mandating greater debt service
payments, a lender’s underwritten debt service coverage ratio requirement will result in less loan
proceeds). Future redevelopment concerns of the government entity will impact the length of the
ground lease. Future redevelopment desire and commitment of the developer will likewise impact the
term. In exchange for the long-term control benefits of a shorter term, the government entity must be
prepared to accept less in the way of immediate ongoing economic benefits. Likewise, in exchange
for the economic benefit and value of a longer term, a developer must be willing to accept future
redevelopment conditions that may be imposed by the government entity. A fifty-year term is short,
and is at the barely acceptable edge of the spectrum for a developer absent additional economic
incentives, such as grants or low cost loans. Sixty-five to seventy-five years, in a combination of
original term plus options, is generally acceptable. A longer term may be available under certain
circumstances.

**Rent Structures**: Most ground leases provide a combination of base rent and income and
appreciation profit sharing. In consideration for its land, government entities customarily receive an
agreed upon fair rental for the land and an upside potential return on their investment, i.e., a
quasi-joint venture position.

**Base Rent**: Base rent discussions focus on the value of the land and the appropriate
assured return to the government entity. Value is a function of what can be built on the land (very
much influenced by the government entity in its public capacity), the expected profitability of the
improvements, and how much of the profitability is attributable to the land. The appropriate base
level of return should be governed by the profit potential of the project and the risk of the project’s
success or failure to the developer. Also, the level of the lessor’s anticipated profit participation
should serve to discount the Base Rent number. Seven to ten percent returns on the “fair market
value” of the land have been seen, with eight percent probably closer to the historical norm. During
initial construction, a nominal “holding rent” is paid to the lessor. Occasionally full base rent will be
required at the outset, but as this reduces the funds available for construction, it is resisted by
developers.

**Holding Rent**: Base rent typically commences upon either completion,
opening for business, or a date certain related to an estimated completion schedule. A “Holding
Rent” is payable following the effective date of the Ground Lease but before commencement of
construction. Depending on the requirements of the DDA or Option Agreement (and, in particular,
the Schedule of Performance), the length of the Holding Rent period will be determined by the status
of the project upon execution of the Ground Lease. Assuming that the developer is spending money
on the development process (and has no income, and, perhaps no financing, from which to make
significant rental payments) these payments may be quite small.

**Base Rent Phase In**: Base rent is frequently phased in consistent with the
projected construction period and economic stabilization. Construction period and pre-stabilization
rent is generally a percentage of the expected initial minimum Base Rent to be paid upon completion
and stabilized operation. There may be increases on dates certain or upon certain trigger events or
percentages of completion. If a project is to be developed in phases, this will normally be a factor in
the determination of the Base Rent. Occasionally a portion of the pre-stabilization Base Rent
payments will be deferred or exchanged for other economic benefits to the government entity
depending on the developer’s ability to finance construction.